No. 85-1736

In The

Supreme Court of the United States

October Term, 1985

JERSEY SHORE STATE BANK,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR PETITIONER

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QUESTION PRESENTED

Whether the Third Circuit Court of Appeals was correct in holding that the Internal Revenue Service does not need to give a third party lender notice pursuant to Section 6303(a) of the Internal Revenue Code of an assessment against an employer for unpaid employee income withholding taxes and Federal Insurance Contribution Act ("FICA") taxes in order for the Internal Revenue Service to obtain judgment against such third party lender for the employer's liability for these taxes under Sections 3505(a) and 3505(b) of the Internal Revenue Code.

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JURISDICTION

The judgment of the court of appeals was entered on January 10, 1986. (J.A. 16). A timely petition for rehearing and rehearing in banc was denied on February 4, 1986. (Pet. App. 25a-26a). The petition for a writ of certiorari was filed on April 22, 1986 and granted on June 2, 1986. This Court has jurisdiction to review the judgment of the court of appeals by writ of certiorari pursuant to 28 U.S.C. § 1254(1).

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STATUTES INVOLVED

Sections 3505 and 6303(a) of the Internal Revenue Code of 1954 (26 U.S.C.) (Pet. App. 50a-52a).

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STATEMENT OF THE CASE

The petitioner Jersey Shore State Bank, (hereinafter referred to as "Jersey Shore" or "the Bank") is an authorized Pennsylvania banking institution with its main office at 115 South Main Street, Jersey Shore, Pennsylvania.[1] (Pet. App. 38a-39a). Pennmount Industries, Inc., (hereinafter referred to as "Pennmount") was a corporation located in Lock Haven, Pennsylvania, engaged in the manufacture of wooden tables and chairs. (Pet. App. 28a). In February of 1976 the Bank began to make commercial loans to Pennmount in the normal course of business. The first loan was for $20,000.00 for working capital. Subsequently, additional loans totalling $270,000.00 were made to Pennmount by Jersey Shore, secured by mortgages on Pennmount property and by specific receivables of Pennmount. (Pet. App. 28a, 46a-47a).

Beginning with the fourth quarter of 1977 and continuing through the first quarter of 1980, Pennmount failed to pay over to the United States federal employee withholding income taxes and FICA taxes which it withheld from the wages of its employees. These taxes are not in dispute. (Pet. App. 28a).

On December 30, 1983, the United States filed suit against Jersey Shore in the United States District Court for the Middle District of Pennsylvania in order to collect all employee withholding taxes and FICA taxes which Pennmount had failed to pay for the fourth quarter of

[1]Jersey Shore State Bank is a wholly owned subsidiary of Penns Woods Bancorp, Inc. Affiliate: Woods Real Estate Development Company, Inc.

1977 through the first quarter of 1980, plus accrued penalties and interest. The Government sought to impose liability on the Bank as a third party lender pursuant to Section 3505 of the Internal Revenue Code of 1954.[2] (Pet. App. 38a-45a, J.A. 5-7).

Count I of the complaint alleged that the Bank had paid wages directly to Pennmount's employees and was accordingly liable under Section 3505(a) for the full amount of the unpaid employment taxes of $76,547.57 plus interest. Count II of the complaint alleged that the Bank supplied funds to Pennmount for the purpose of paying wages, knowing that Pennmount did not intend or would be unable to pay withholding taxes. Accordingly, Count II alleged that the Bank was liable under Section 3505(b) for the unpaid employment taxes in an amount not exceeding 25% of the amount lent; in this case, $72,069.00 (Pet. App. 38a-45a).

Jersey Shore filed an Answer admitting that it had provided money to Pennmount as commercial loans and raised as a defense, *inter alia*, to both Counts I and II of the Government's complaint the failure of the Government to provide it with notice within sixty days of the making of any assessment against Pennmount for nonpayment of federal withholding taxes and FICA taxes as required by Section 6303(a). (Pet. App. 46a-49a).

The Government moved for summary judgment against the Bank on Count I relating to the liability of

[2]Statutory references are to sections of the Internal Revenue Code of 1954 (26 U.S.C.) as amended, and as applicable to the time periods involved in this case, unless otherwise indicated.

the Bank under Section 3505(a). The Bank cross moved for summary judgment on Counts I and II relying on the failure of the United States to give notice to the Bank of the assessments against Pennmount as required by Section 6303(a). The United States admitted that the Bank had not been given notice with respect to the assessments against Pennmount which the Government sought to collect from the Bank and asserted that no such notice was required. (Pet. App. 3a).

The district court on March 20, 1985, entered judgment in favor of Jersey Shore on its motion for summary judgment following the rationale of the Seventh Circuit Court of Appeals in *United States v. Associates Commercial Corp.*, 721 F. 2d 1094 (7th Cir. 1983) (Pet. App. 33a-38a).

The Government filed an appeal from the decision of the district court in favor of the Bank with the United States Court of Appeals for the Third Circuit on April 12, 1985. (J.A. 1).

The Third Circuit by a 2-1 panel majority reversed the decision of the district court on January 10, 1986, with a dissenting opinion filed by Judge Weis (Pet. App. 1a-24a).

Jersey Shore filed a timely petition for rehearing which was denied on February 4, 1986. (Pet. App. 25a). Subsequently, Jersey Shore filed a petition for writ of certiorari with this Court on April 22, 1986, which was granted June 2, 1986.

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SUMMARY OF ARGUMENT

Section 6303(a) of the Internal Revenue Code requires that notice of a tax assessment be given to "each person liable for the unpaid tax." Jersey Shore is a person whom the Government seeks to hold liable for unpaid taxes owed by Pennmount. Jersey Shore was therefore entitled to receive notice of a tax assessment against Pennmount within sixty days of the assessment having been made as required by the plain language of Section 6303(a).

Section 3505 of the Code imposing derivative third party tax liability on lenders was enacted in 1966, twelve years after Section 6303(a) became part of the Code. Congress did not change the language of Section 6303(a) when it enacted Section 3505 to provide that notice should be given only to those persons against whom a tax had been assessed. There is no legislative history which can be cited to show that Congress in enacting Section 3505 intended to exempt the Government from the statutory notice requirements of Section 6303(a).

The failure of the Government to provide notice of a tax assessment to a third party lender results in a fundamental unfairness in the treatment afforded a person primarily liable for the tax and a lender who is secondarily liable. While an employer receives notice of a tax assessment within sixty days of it being made, the first notice a lender receives occurs when the Government files suit against it, which can be nine years after the tax is due. In the interim period lending personnel can change and records can be lost which would enable the lender to defend itself adequately against Section 3505 liability.

The Government seeks to have the advantage of an extended six year statute of limitations under Section 6502 of the Code against a third party lender and should likewise shoulder the burden of providing notice to the lender of the tax assessment as required by the express language of Section 6303(a).

In requiring the Internal Revenue Service to give notice, there is no undue administrative burden in determining the lenders who should receive the notice. The Internal Revenue Service has three years to make an assessment before the sixty day period for giving notice begins to run. During this period the IRS may use its extraordinary investigative powers to determine the parties who should be given notice. If the Internal Revenue Service determines that it is unable to comply with the existing notice requirement, it should petition Congress to change the statute and not ask the Court to make a strained interpretation of the plain meaning of the statutory language.

The Third Circuit misconstrued the legislative history of the enactment of Section 3505 in citing sections of the House and Senate reports which refer to the amendment to Section 1 of the Miller Act, 40 U.S.C. § 270a(d), requiring contractors to provide bonds on public work contracts to guarantee payment of employer withholding and FICA taxes. Congress had a clear concern in amending the Miller Act, *supra*, that third party sureties receive notice of unpaid employer taxes before liability could be imposed on them. Such notice is also required to be given third party lenders under Section 6303(a) of the Code which remained unchanged after the enactment of Section 3505 and requires that "each person liable for the unpaid tax" should receive notice of the tax assessment.

ARGUMENT

I. SECTION 6303(a) OF THE CODE REQUIRES THAT NOTICE OF A TAX ASSESSMENT BE GIVEN TO A THIRD PARTY LENDER.

A. The statutory language of Section 6303(a) and the legislative history of Section 3505 require that notice of a tax assessment be given to a third party lender.

Section 6303(a) of the Code is clear in its requirement that once the United States has made a tax assessment that notice of that assessment must be given within sixty days "to each person liable for the unpaid tax." (Pet. App. 51a). As noted by Judge Weis in his dissent in the present case:

> "The reference to 'each person liable' in § 6303 is not in the least ambiguous. In the case at hand, the government contends that defendant is liable for the tax. Therefore, it seems inescapable that defendant should have been given notice.
>
> "The IRS wishes us to redraft that section so that it requires notice only to those individuals against whom taxes have been assessed. The reasons offered for this revision have some logic and would possibly ease administrative burdens on the government, but the arguments are directed to the wrong forum. They should be presented to Congress, not the courts." (22a).

In the present case, the Bank made commercial loans to Pennmount in the normal course of business. More than five years after Pennmount had begun to fail to make payment of federal employment and FICA taxes due to the United States, the Government filed the present suit against the Bank for third party derivative tax liability

pursuant to Sections 3505(a) and 3505(b) of the Code. At no time did the United States provide notice to the Bank of any assessment which it had made for the unpaid taxes against Pennmount as required under Section 6303(a) of the Code (Pet. App. 31a, 47a).

Section 3505 of the Code was enacted by Congress in order to correct the situation which existed where:

> "Under present law, only 'employers' are liable for income, social security, and railroad retirement taxes required to be withheld and deducted from wages. There are cases, however, where persons other than the employers directly, or indirectly pay the wages. Where this occurs, problems have arisen because, in some instances, these other persons have paid employees only the 'net' wages and have not paid, either to the employees or to the Government, the withholding taxes due the Government." H. R. Rep. No. 1884, 89th Cong., 2d Sess. at 20; S. Rep. No. 1708, 89th Cong., 2d Sess. at 21.

Nowhere, however, in the legislative history, is there any indication that Congress intended to enact Section 3505 in a vacuum, free of any requirements that exist under the Code for the imposition of liability on a third party lender.

As noted by this Court in the case of *Consumer Product Safety Commission v. GTE Sylvania, Inc.*, 447 U.S. 102 (1980), the beginning point of interpreting any statute is the language of the statute itself. Justice Rehnquist writing for the Court stated: "We begin with the familiar cannon of statutory construction that the starting point for interpreting a statute is the language of the statute itself. Absent a clearly expressed legislative intention to

the contrary, that language must ordinarily be regarded as conclusive." 447 U.S. at 108.

The comments of Rep. Byrnes on the floor of the House of Representatives speaking in support of the Federal Tax Lien Act of 1966, Pub. L. 89-719, 80 STAT. 1125, indicated that:

> "In addition to the changes relating to the priority of the Federal tax lien, the bill makes many other changes in the rules governing the seizure of property for the collection of tax, the release of liens, and other matters generally related to the collection by the Government of delinquent tax liabilities. The changes are intended to make collection procedures more equitable and more convenient to taxpayers, the Government, and the general public." 112 Cong. Rec. at 22227.

There is no record in the House or Senate reports or the floor debates in Congress that Section 3505 was intended to be placed into the Internal Revenue Code without being subject to the notice provisions of Section 6303(a). It is submitted that Congress must be presumed to have been aware of the statutory provisions of the Internal Revenue Code when it enacted the amendments to the same in the Federal Tax Lien Act of 1966, *supra*. The language of Section 6303(a) remained unchanged after Section 3505 was enacted into the Code. Absent any legislative history to the contrary in the enactment of Section 3505, the plain meaning of Section 6303(a) requires that the Government give notice of a tax assessment to a third party lender within sixty days of such assessment.

As noted by Judge Weis in the instant case in his dissent in the Third Circuit:

> "In this case, I cannot even say with assurance that the addition to the statute that the IRS proposes was inadvertently omitted. Certainly, the legislative

history of § 6303 provides no basis for such a belief. Moreover, the legislative history of § 3505 does not suggest that notice should not be provided lenders who may be secondarily liable. 'Congressional silence no matter how "clanging" cannot override the words of the statute.' *Sedima v. Imrex Co., Inc.*, 53 U.S.L.W. 5034, 5038 n. 13 (June 25, 1985)." (Pet. App. 22a-23a).

If Congress had intended that the provision of Section 6303(a) relative to the sixty days notice of an assessment were not to apply to persons whom the Government seeks to hold liable under Section 3505, an exception would have been placed in the statute to indicate this fact. Such an exception is not, however, present.

B. The Seventh Circuit has decided that notice of a tax assessment must be given to a third party lender.

The Seventh Circuit Court of Appeals in *United States v. Associates Commercial Corp., supra*, decided that Section 6303(a) mandates notice by the Government to third party lenders upon whom the Government seeks to impose derivative tax liability under Section 3505.

In *Associates, supra* the Government made an assessment against the employer, Dot Engravers. Inc., for unpaid employee withholding taxes. Associates, as lender, had previously made commercial loans to the employer. No notice of the filing of the assessments against the employer was given to the lender. Subsequently, six years and three months after the first assessment was made, the Government sued the lender for the unpaid taxes of the employer alleging liability pursuant to Section 3505(b) of the Code. The Seventh Circuit stated: "We hold that Section 6303(a) mandates notice to a lender subject to

Section 3505(b) liability and that this civil proceeding is barred because of the absence of such statutorily required notice." 721 F. 2d at 1098.

The Court in *Associates, supra,* reviewed the previous decisions that the Government had relied upon in two District Court opinions, *United States v. Marine Midland Bank*, 544 F. Supp. 268 (W.D.N.Y. 1982) and *United States v. First National Bank of Carbondale*, 499 F. Supp. 51 (M.D.Pa. 1980). The Court in *Associates, supra,* found that such reliance by the Government was misplaced. The Court noted that:

> "In both cases the district courts based their opinions on the absence of a notice requirement in the Treasury Regulations promulgated under Section 3505 rather than looking to Section 6303(a) itself. 544 F. Supp. at 271; 499 F. Supp. at 53. Furthermore the silence of Section 3505(b) and the regulations thereunder does not create an inference as to whether Section 6303(a) requires notice since, as Judge Will noted, Section 3505(b) itself merely identifies the circumstances under which a lender's liability arises. The procedures for enforcing Section 3505(b) and other tax provisions are contained in Subtitle F of the Internal Revenue Code, of which Section 6303(a) is one provision. 548 F. Supp. at 175, n. 1. On the other hand, Section 3505(b) is part of Subtitle C dealing with employment taxes." 721 F. 2d at 1099.

C. The analysis of Section 6303(a) by the Third Circuit in the instant case failed to consider the effect of the enactment of Section 3505.

In the instant case the Third Circuit reviewed the administrative changes made by the President's reorganization plans with regard to modifying the 1939 Internal Revenue Code to abolish the office of Collector of Internal

Revenue, thereby combining the function of the tax collector as part of the duties of the Secretary of the Treasury. The Third Circuit indicated that Congress enacted Section 6303(a) into the Code in 1954, incorporating the administrative changes previously adopted by the President's Reorganization Plan of 1950, Reorg. Plan No. 26 of 1950, 15 Fed. Reg. 4935 (1950), *reprinted* in 5 U.S.C.A. app. at 274-75 (West 1967) and the Reorganization Plan of 1952, Reorg. Plan No. 1 of 1952, 17 Fed. Reg. 2243, *reprinted* in 5 U.S.C.A. app. at 280-81 (West 1967). (Pet. App. 14a-17a).

The Third Circuit held that there had been no change in the law by Congress between the Internal Revenue Code of 1939 and the 1954 Code when Congress enacted Section 6303(a) in the 1954 Code. (Pet. App. 17a). The Court noted:

> "Under these circumstances, we find that Congress did not intend to change the law with respect to who must receive notice when it enacted section 6303(a). Congress was fully aware of the changes brought by Reorg. Plan No. 26 and Reorg. Plan No. 1 when it enacted the 1954 code. It only follows that the Congress would adapt the language of the code to fit the existing organization of the Department of the Treasury and the Internal Revenue Service. Thus, absent any legislative history to the contrary, we find that section 6303(a), like its predecessor statute under the 1939 Code, only requires notice to those individuals against whom the government can proceed administratively." (Pet. App. at 17a).

The difficulty with this analysis, however, is it ignores the fact that Section 3505 of the Code was enacted not as part of the 1954 revision but 12 years later in 1966. Congress may be presumed to have been aware of the ex-

press language of Section 6303(a) of the Code when it enacted the amendments under the Federal Tax Lien Act of 1966, *supra,* which included the new Section 3505 imposing derivative liability on third party taxpayers.

In enacting Section 3505 Congress created an additional group of persons who would be liable for taxes. Absent any legislative history with regard to Section 3505 indicating that a lender, as a person liable for the unpaid tax of the employer, should not also receive notice of the assessment, Section 6303(a) clearly requires such notice of assessment to be given. There is nothing in the opinion of the Third Circuit nor, anything in the legislative history of the enactment of Section 3505 which establishes that this section was enacted by Congress without being subject to the plain language of Section 6303(a) requiring notice of assessment "to each person liable for the unpaid tax." Clearly, a third party lender whom the Government seeks to hold liable for an employer's taxes is one such person.

The Third Circuit also cited the holdings in *United States v. Erie Forge Company,* 191 F. 2d 627 (3rd Cir. 1951), *cert. denied,* 343 U.S. 930 (1952) and *Jenkins v. Smith,* 99 F. 2d 827 (2d Cir. 1938) (per curiam) accepting the Government's contention that it may bring suit for taxes where it has not assessed those taxes. (Pet. App. 11a-17a).

Jenkins, supra, and *Erie Forge, supra,* both dealt with pre-1954 Sections of the Internal Revenue Code in which the tax collector and not the Secretary of the Treasury,

was required to give notice within the ten days after assessment to each person liable for the taxes.[3]

Under the provisions of the Internal Revenue Code applicable in both *Jenkins, supra,* and *Erie Forge, supra,* the tax collector was authorized to collect taxes only by administrative remedies. He was not statutorily authorized to institute legal proceedings nor was there a statutory claim for derivative tax liability against third persons as exists under Section 3505.

After *Jenkins, supra,* and *Erie Forge, supra,* were decided, the Internal Revenue Code of 1954, Title 26, Subtitle F, legislatively merged the functions of collection and initiation of legal proceedings into one office of the Secretary of the Treasury. It is the Secretary of the Treasury who assesses taxes now pursuant to Section 6201, pursues administrative remedies under Section 6331 and authorizes the initiation of civil proceedings for tax collection under Section 7401, all of the aforesaid being contained within Subtitle F.

Section 3505 of the Code was not enacted, however, until 1966 pursuant to the Federal Tax Lien Act of 1966, *supra.* With the enactment of Section 3505, Congress did not exempt the Secretary of the Treasury from the notice provisions required under Section 6303(a).

In *Associates, supra,* the Seventh Circuit decided that since the same person, *i.e.* the Secretary of the Treasury, now controls the post-assessment administrative and litigation collection procedures under Subtitle F, that the general Section 6303(a) notice rule of Subtitle F applies equally to the Secretary, whether instituting administrative collection proceedings or legal collection proceedings. The Seventh Circuit interpreted both *Jenkins, supra,* and *Erie Forge, supra,* to hold that the person who fails to give the required notice to the taxpayer is barred from exercising all of the remedies to which he is statutorily empowered. Since the Secretary of the Treasury is now empowered to proceed with collection by litigation as well as by administrative remedy, both *Jenkins* and *Erie Forge* support the holding of the Seventh Circuit in *Associates. See: Associates, supra,* at 1100.[4]

[3]26 U.S.C. Section 1545 in *Jenkins, supra,* and 26 U.S.C. Section 3655 of the Internal Revenue Code of 1939 in *Erie Forge, supra.*

[4]The argument of the Government before the Third Circuit that the Secretary of the Treasury is not authorized to proceed with litigation to collect the tax because the Justice Department is the litigating arm of the Government ignores basic agency law concepts. The Justice Department only institutes litigation at the request of the Secretary under Section 7401.

For the statutory history with regard to the distinction between the functions of the tax collector and the tax commissioner and the Department of Justice see the following: Act of July 1, 1862, ch. 119, 12 Stat. 432, 444, Section 31; Act of June 30, 1864, ch. 173, 13 Stat. 223, 239, Section 41; Act of July 13, 1866, ch. 184, 14 Stat. 93, 111, Section 9; Act of June 22, 1870, 16 Stat. 162, Sections 3, 5 and 16; Revised Statutes of 1878, Sections 3182, 3184, 3213 and 3214; Revenue Act of 1926, ch. 27, 44 Stat. 9, Section 280 (a); Internal Revenue Code of 1939, Sections 3654, 3655 and 3740 and Internal Revenue Code of 1954. 26 U.S.C. Sections 6501, 7401.

II. THE FAILURE OF THE GOVERNMENT TO PROVIDE NOTICE OF A TAX ASSESSMENT PLACES THE LENDER AT A FUNDAMENTAL DISADVANTAGE.

A. Additional procedural benefits are conferred upon the Government against a third party lender by the filing of a tax assessment against an employer.

The majority opinion of the Third Circuit is the present case failed to take account of the fact that the filing of the tax assessment confers additional procedural benefits upon the Government. Under Section 6501 of the Code, once the IRS has made an assessment against an employer within three years from the time that the tax liability arises, then it has the benefit of an additional six year period in order to file suit against either the employer or a third party lender. (Pet. App. 50a-51a). The Government, having the advantage of an additional six years in which to bring suit against a third party lender, refuses responsibility for giving such a taxpayer notice of the tax assessment as required by Section 6303(a). Such notice would allow the third party lender to evaluate its ongoing relationship with the employer-borrower, knowing that the Government intends to hold the lender liable for the taxes.

Both the lender and the employer are similarly situated in that both are taxpayers as defined in Section 7701(a)(14) of the Code, who are being held liable for the same taxes, *i.e.* unpaid FICA and employer withholding taxes. *See*: Westin, Richard A., *Lexicon of Tax Terminology* at 772 (New York, 1984).

Under Section 6303(a) the lender and the employer are also both persons "liable for the unpaid tax." However, the lender, under the Government's interpretation of the statute, which was adopted by the Third Circuit in the instant case, is not entitled to notice of the tax assessment, while the employer is. Such a distinction which is contrary to the plain language of Section 6303(a) creates a fundamental unfairness between the treatment afforded by the Government to an employer and that given a third party lender.

The employer has the advantage of receiving notice within sixty days of the assessment and the lender does not. As noted by Judge Weis in his dissent in the Third Circuit:

> "The net effect of the Code revision urged by the IRS is to give less procedural protection to one secondarily liable than to the primary obligor. The notice of assessment will alert the taxpayer directly liable to the lengthened statute of limitations. He may then preserve pertinent records, arrange for payment, compromise, or take other steps in his own best interests. Without notice of the assessment, however, the party under § 3505 may not be alerted to his continuing exposure and concomitant risk. I am not convinced that Congress intended such an anomalous result." (Pet. App. 23a).

Having rejected the requirement of notice to a third party lender under Section 6303(a), the Government then turns around and relies upon Section 6502(a) to extend the statute of limitations against the lender for another six years without having provided any previous notice as required by Section 6303(a).

It is submitted that such an arrangement creates a fundamental unfairness with regard to any conceivable interpretation of the Internal Revenue Code and more es-

pecially so, where such an interpretation does violence to the plain statutory language of Section 6303(a).

It should be noted that in the instant case, without the benefit of the extended statute of limitations, that the entire suit brought by the Government would be a nullity. The last assessment against Pennmount was made for the tax quarter ending March 31, 1980, with notice of assessment given to Pennmount on July 14, 1980. (J.A. 5-7, Pet. App. 45a). The Government did not file suit in the district court against the Bank until December 30, 1983, more than three years after the period for suit would have elapsed absent the extension of the statute of limitations against the lender provided for under Section 6502(a) of the Code. (J.A. 3).

As further noted by Judge Weis in his dissent:

> "It bears mentioning that the dispute here is not about a meaningless formality. The assessment of taxes against Pennmount had the effect of enlarging the statute of limitations against defendant bank for six years. 26 U.S.C. § 6502(a)1. *United States v. Associates Commercial Corp.*, 721 F. 2d 1094, 1097 (7th Cir. 1983). The likelihood of prejudice because of the loss or destruction of records by one secondarily liable is real and substantial. *United States v. Associates Commercial Corp.*, 548 F. Supp. 171, 174 (N.D. Ill. 1982)." (Pet. App. 23a).

B. The Eleventh Circuit has required notice of a tax assessment to be given to a third party lender.

The Eleventh Circuit Court of Appeals in *United States v. Merchants National Bank of Mobile*, 772 F. 2d 1522 (11th Cir. 1985) (per curiam), petition for *cert.* pending to No. 85-1480 has likewise adopted the rationale of

the Seventh Circuit in *Associates*, supra. The Court reviewed the decision in *Associates*, stating:

> "The United States argues on appeal that it was not required to give MNB the § 6303(a) notice of assessment as a prerequisite to suit against MNB for Dri-Mix's unpaid employment taxes. The Seventh Circuit, in *Associates Commercial Corp.*, rejected an identical argument. In that case, the court noted that § 6303(a) 'requires that notice of an assessment of unpaid taxes must be provided to "each person liable for the unpaid tax" within sixty days after the assessment was made, unless otherwise provided by the Internal Revenue Code.' 721 F. 2d at 1098. Since § 3505 did not exempt from § 6303(a) lenders potentially liable, and since no other exemption could be found, the court concluded that the lender, a 'person liable for the unpaid tax' within the meaning of § 6303(a), was entitled to notice of assessment of the unpaid tax. 721 F. 2d at 1098. The court held that the government's failure to provide the statutorily required notice barred its suit. *Id.* We agree with the Seventh Circuit's reading of the applicable statutory provisions and hold that the United States' failure to provide MNB with the § 6303(a) notice bars the present suit against MNB.[1]" 772 F. 2d at 1523-24. (*footnote omitted*)

Jersey Shore is not suggesting that Section 6303(a) should be interpreted in such a manner as to make a fortress out of the dictionary. The interpretation urged by the Government, however, results in less procedural protection to a third party taxpayer who is being held liable for the tax than to the employer. This interpretation would extend the statute of limitations against the lender for an additional six years without affording the lender the same statutory notice of the tax liability as the primary taxpayer receives. Such an interpretation com-

pletely vitiates the plain language of Section 6303(a) without any legislative history showing a Congressional intent to the contrary.

III. THE SUBSTANTIVE REQUIREMENTS OF SECTION 3505 LIABILITY DO NOT OBVIATE THE REQUIREMENTS OF NOTICE TO A THIRD PARTY LENDER UNDER SECTION 6303(a)..

The Third Circuit in its opinion in this case and the Ninth Circuit in the case of *United States v. Hunter Engineers & Constructors, Inc.*, 789 F. 2d 1436 (9th Cir. 1986), both relied upon the substantive requirements for Section 3505 liability in order to justify their view that no notice of a tax assessment was required to be given to a third party lender pursuant to Section 6303(a) of the Code.

The Third Circuit in the instant case noted:

> "Careful consideration of the substantive requirement of section 3505 further buttresses our conclusion that section 6303(a) does not require notice to parties like Jersey Shore. In construing section 6303(a) to require notice to third parties like Jersey Shore, the Seventh Circuit was apparently concerned that unless such notice be given, third parties like Jersey Shore would have no reason to suspect that they be liable under section 3505, to their ultimate prejudice. *See* 721 F. 2d at 1099-1100. A similar concern has been voiced by other courts that have addressed this question. *See, e.g., United States v. American Bank & Trust*, No. 84-5624, slip op. at 4-5 (E.D.Pa. Aug. 9, 1985) (observing that 'any potential burden [on the government] is outweighed by the possibility of prejudice to the lender not receiving notice'); *United States v. Associates Commercial Corp.*, 548 F. Supp. 171, 174 (N.D. Ill. 1982).

> "However, in light of the burden of proof placed upon the government by section 3505, we find this concern to be generally unfounded." (Pet. App. 17a-18a).

The Ninth Circuit likewise noted:

> "While we agree that this statutory scheme does not wholly negate the possibility of prejudice to the lender, it is clear that Congress sought to impose liability only when the government could meet its burden of proof under section 3505. Thus, we conclude that a lender who is liable under section 3505 must have necessarily been intimately involved in the employer's failure to pay taxes and consequently does not need formal notice of such liability to enable it to defend itself in a subsequent action." *Hunter Engineers & Constructors, Inc., supra,* at 1441.

Such an analysis clearly includes within it as a logical predicate the belief that the lender is liable for the tax in the first instance and therefore suffers no prejudice by virtue of not having received notice of assessment of the tax under Section 6303(a). The lender therefore is not prejudiced by being sued up to nine years later by the Government after the tax has been assessed against the employer.[5] While this may be true in the case of a lender who in fact is liable under Section 3505, the question arises as to what effect the lack of notice has on the innocent lender.

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[5]For example, if a lender makes a loan at the beginning of a quarterly period, the employment tax return would not be due until four months after the start of the quarter. Treas. Reg. § 31.6071(a)-1. The Government would then have three years from that date within which to make the assessment for unpaid taxes. 26 U.S.C. § 6501(a). After the assessment, it would have an additional six years within which to institute suit against the lender under Section 3505. 26 U.S.C. § 6502(a).

The corporate officers of a financially ailing or bankrupt company will have a great interest in reconstructing their recollection of past events in order to foist liability for taxes on a lender under Section 3505. Obviously, in the situation where the Government is proceeding to collect past due taxes, the interests of corporate officers facing potential liability under Section 6672 of the Code are diametrically opposed to that of an innocent lender on whom the Government is seeking to place liability for the taxes under Section 3505. *See: United States v. American Bank and Trust, supra,* appeal pending to No. 85-1615 (3rd Cir.). The testimony of the corporate officers can best be rebutted by the testimony of the lender's loan officers. However, given the passage of time many of the loan officers in any financial institution will have moved, changed jobs and may be unable to be located or may have died.

Nine years later when the Government returns to sue the lender, recollections of loan transactions may be inexact; more particularly so in the case where the lender is not culpable and would have no reason to believe that it faces liability for someone else's taxes under Section 3505.

The only way to prevent this situation from arising is to require the Government to adhere to the statutory mandate of Section 6303(a) giving the lender, as well as the employer, notice of the tax assessment.

IV. NOTICE OF ASSESSMENT IS A NECESSARY STEP WHICH THE GOVERNMENT MUST FOLLOW IN ITS COLLECTION PROCESS AGAINST A THIRD PARTY LENDER.

A No undue administrative burden would be placed on the Government in complying with the notice provisions of Section 6303(a).

The Government argues that requiring notice of a tax assessment to be given to third party lenders would impose an undue administrative burden on the IRS (Pet. App. 19a-22a). The argument of the Government, however, ignores the provision of Section 6501(a) of the Code which allows the IRS three years from the time that the employer's tax return has been filed to impose an assessment against the taxpayer (Pet. App. 51a). Accordingly, the period for investigation which the Government argues is impossible to perform within sixty days is inapplicable, inasmuch as the Government has three years to file the assessment against the employer before the running of the sixty day notice period begins. It is during the latter time that adequate investigation could be made by the Government with regard to third party lenders whom the Government wishes to hold liable under Section 3505 of the Code.[6]

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[6]See Gombinski, *A Noticeable Restriction: Imposing Section 3505 Liability After Associates,* 62 Taxes—The Tax Magazine 757 (Nov. 1984), where it is noted: "Since Section 6501 would allow the government to make this separate assessment any time within three years from the date that the employer's tax return is deemed to be filed, the government would be afforded reasonable time in which to determine the existence of those lenders who may be liable for the employer's unpaid tax." *Id.* at 770.

The provisions of Section 3505 of the Code imposing liability on third party lenders constitute an extraordinary remedy which Congress enacted in favor of the Government to hold third parties liable for unpaid taxes. H. R. Rep. No. 1884, 89th Cong., 2d Sess. at 20-21; S. Rep. No. 1708, 89th Cong., 2d Sess. at 21-23.

No exception is present in Section 6303(a) to indicate that persons whom the Government seeks to hold liable under Section 3505 should not be given notice of the tax assessment.

Likewise, if one accepts for purposes of argument the Government's contention that an assessment could not be statutorily made against the Bank for Pennmount taxes, the issue of the notice of the assessment is still present. (Pet. App. 12a-13a). The central issue in the present case is notice of the assessment to a third party, *i.e.* the Bank, whom the Government seeks to hold liable for the tax of the employer, and not the assessment itself.

As a policy matter, providing timely notice to a lender of an assessment against an employer would put the lender on notice of liability and allow the lender to evaluate its ongoing relationship with the borrower. In the present case the first notice of liability that Jersey Shore received was the filing of the lawsuit in District Court, almost six years after the first tax liability arose. (Pet. App. 34a).

Obviously, if the Government is seeking to eliminate unpaid tax liabilities, the best place to begin would be to provide the third party lender with notice of the fact that the employer has failed to make payment of withholding and FICA taxes. The lender could then take steps to monitor the employer's payment of these taxes, or alternately, could stop funding the employer completely, thereby eliminating the accrual of unpaid taxes.

Additionally, under Section 6204 of the Code the Government is allowed to make a supplemental assessment where a prior assessment is imperfect or incomplete "in any way." Under Section 6204 such assessment would allow the Government to in effect reassess the tax against the employer and provide the lender with timely Section 6303(a) notice of the additional assessment. The Government would in such event have three years after the tax return of the employer is filed in order to make a determination with regard to potential liability of a lender, make a supplement assessment and then an additional sixty days afterwards to provide the lender with notice of that supplemental assessment.[7]

Finally, if the Government still feels aggrieved by the notice requirement of Section 6303(a), it could petition Congress to change the statute and not ask the Court to make a strained interpretation of the plain meaning of the statutory language of Section 6303(a).

B. The Ninth Circuit misconceived the nature of the notice requirement under Section 6303(a).

The Ninth Circuit in *Hunter Engineers & Constructors, Inc., supra,* followed the rationale of the Third Circuit holding that no notice was required to be given to a lender under Section 6303(a) of the Code in order for the Government to impose liability upon such lender pursuant to Section 3505.

The Ninth Circuit adopted the reasoning of the Third Circuit noting that:

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[7]*See:* Gombinski, *supra* at 771.

"Section 6303(a) states that 'each person liable for the unpaid tax' shall be given notice within sixty days of assessment. 26 U.S.C. § 6303(a) (1982). It does not provide that only 'taxpayers' or 'persons assessed against' are to be given notice. Further, the government does not contend that Congress 'otherwise provided,' that notice need not be given to lenders who are liable for taxes assessed against an employer. If section 6303(a) required nothing more than notice 'to each person liable for the unpaid tax,' we would be persuaded that such clear and unambiguous language 'be regarded as conclusive.' *Consumer Product Safety Commission v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980). But the statute also requires the notice to state the amount owing and to make demand for payment. 26 U.S.C. § 6303(a). The court in *Jersey Shore* found these added requirements to be significant in determining the intent of Congress. *Jersey Shore*, 781 F. 2d at 978." *Hunter Engineers & Constructors, Inc., supra*, at 1438.

The Ninth Circuit, however, did not address the fact that Section 6303(a) of the statute specifically does not provide the form of the notice which must be given "to each person liable for the unpaid tax." It is submitted that it is only the Government's own construction of the statute which prevents a third party lender from receiving notice of the assessment. Clearly any third party lender could receive notice from the Government that an assessment had been made against an employer for a designated amount of unpaid taxes and indicating demand for payment with the statutory liability of the lender set forth under Section 3505 of the Code.

Such notice of assessment would put the innocent lender on notice that the Government had the statutory right to seek collection of the tax from the lender as well as the employer. The lender would then be able to take steps to protect itself including the assembling of records

and making a determination as to whether or not it intended to extend further credit to the employer, knowing that the employer had failed to pay his FICA taxes and employee withholding taxes to the Government.

It should be noted that the Government is not relegated under the Code from seeking collection against the employer first, but has a choice of options as to proceeding against the employer, the lender, or potentially corporate officers of the employer as well under Code Section 6672.[8] Given notice as required under Section 6303 (a), the lender may avoid the unfortunate situation in which the Government returns to seek collection of employer taxes against an innocent lender up to nine years after the tax has been assessed, with the first notice that the lender now receives being the lawsuit filed against it in the district court by the Government. The lack of notice is particularly unfair to the lender in the situation where the corporate employer has gone bankrupt as in the instant case and the chief corporate officer is no where to be found when the Government returns to seek collection of the corporate tax against the lender. (Pet. App. 47a; doc. no. 17, Glossner deposition at 30).

The Ninth Circuit also misconstrued the requirement of providing notice of an assessment to a third party taxpayer under Section 6303. The Ninth Circuit found that:

> "Aside from congressional intent, we conclude that a shorter limitations period for lenders than employers would serve to thwart the government's efforts to collect the tax liabilities from the employer. The government would be forced to file an action against

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[8]In the present case there is no record that the Government first attempted to collect the tax liability from corporate officers of Pennmount utilizing Section 6672 of the Code before proceeding against Jersey Shore.

the lender within three years of the assessment even if collection efforts against the employer were ongoing." *Hunter Engineers & Constructors, Inc., supra,* at 1441.

Such an argument, however, misinterprets the relationship between Section 3505 and Section 6303(a) under either position argued by third party lenders or the Government. The Government is urging that no notice of an assessment should be required in order to extend the statute of limitations period against the lender. The Bank, as petitioner in the present case, is requesting that notice be provided to a third party lender under Section 6303 (a) in order to justify the extended statute of limitations period. The Bank, as a third party lender, is not requesting special treatment differing from that afforded an employer with regard to the extended statute of limitations. The Bank does not wish to see a shorter statute of limitations period applicable to it as opposed to an employer. What the Bank is asking for, however, is that it be accorded the same treatment as an employer receives with regard to the issue of notice. As a matter of fairness and statutory right, the Bank is entitled to receive notice of the tax assessment at the same time that the employer does in order for the Government to have the right for the statute of limitations to be extended against the Bank for an additional six year period after the assessment is made.

V. THE THIRD CIRCUIT MISAPPREHENDED THE LEGISLATIVE HISTORY OF SECTION 3505 WITH THAT OF THE MILLER ACT, 40 U.S.C. § 270a (d).

The majority opinion of the Third Circuit misapprehended the legislative history with regard to the enactment of Section 3505 of the Code. The opinion in interpreting the meaning of Section 3505 of the Code made

reference to the Congressional Reports of the Senate and House, quoting the language from those sections of the reports which related not to the enactment of Section 3505 of the Code but to the amendment to Section 1 of the Miller Act, 80 STAT. 1139, 40 U.S.C. § 270a(d), referencing the requirements for performance bonds on public works. (Pet. App. 18a-19a). The latter amendment was enacted as part of the Federal Tax Lien Act of 1966, *supra,* which also included enactment of Section 3505 of the Code.

The majority opinion noted: "Although we do not intend to downplay the potential burden resulting from our construction of section 6303(a), we find the legislative history of section 3505 quite instructive on the question of prejudice to parties like Jersey Shore." (Pet. App. 18a).

In enacting the amendment to Section 1 of the Miller Act, *supra,* Congress plainly provided for notice to be given to a surety of unpaid employer taxes in order for the surety to be held liable on its bond. (Pet. App. 52a). Obviously, Congress in enacting the aforesaid amendment to the Miller Act was cognizant of the prejudice which would result to a surety on its bond without prior notice of unpaid employer taxes.

Congress at the same time in enacting Section 3505 of the Code had already provided for notice to third party lenders by virtue of the requirement of Section 6303(a) of the Code mandating notice of the assessment to "each person liable for the unpaid tax."

The amendment to the Miller Act clearly evidences a Congressional concern that a third party should not be

held liable for taxes of an employer without having received advance notice of the unpaid taxes.

While the legislative discussion in the House and Senate Reports regarding Section 3505 of the Code appears in part E1 of the reports, the language cited by the Third Circuit in the instant case, is contained in part E2 of both the House and Senate Reports which discuss the amendment to the Miller Act, *supra.* (Pet. App. 18a-19a).

The language of the amendment to the Miller Act requiring performance bonds from contractors in order to insure payment of government taxes associated with payrolls, comports with the view expressed in the majority opinion of the Third Circuit that sureties and lenders are in essence the better risk bearers to include the costs of potential payroll tax liabilities in their premiums or as part of their loan security. (Pet. App. 18a-19a). Such an interpretation would be consistent with the performance bond requirements of the Miller Act, *supra,* when sureties are acting as obligors on a bond, or lenders are acting as guarantors of payroll taxes on a loan.

The language from the House and Senate Reports as quoted by the Third Circuit does not comport, however, with its interpretation of the Congressional purpose in enacting Section 3505 of the Code. (Pet. App. 18a-19a). As the Third Circuit notes, liability under Section 3505 of the Code arises when the lender has actual knowledge that the employer does not intend to or will not pay over the taxes required to be withheld, or alternately, is itself directly paying net wages without payment of the payroll taxes. (Pet. App. 18a). The question arises as to why, given such a scienter requirement under Section 3505,

would the Senate and House Reports quoted by the Third Circuit, purportedly as an interpretation of Section 3505 of the Code, indicate that lenders could protect themselves against such losses attributable to withholding taxes "by their including the amounts in their loans and taking adequate security." (Pet. App. 18a-19a, citing S. Rep. No. 1708 at 23; H.R. Rep. No. 1884, at 22).

If the language of the legislative history cited in the Third Circuit opinion in the instant case applies to Section 3505, then the above referenced language in the reports is not logical inasmuch as there would be no need for lenders to include tax liabilities in their loans, as liability for such payroll taxes could never result under Section 3505 absent some volitional cognitive act on the part of the lenders with regard to the nonpayment of payroll taxes of a contractor.

Inasmuch as such an interpretation results in a nullity, it is submitted that the language cited by the Third Circuit from the House and Senate Reports actually is a commentary on the amendment to Section 1 of the Miller Act, *supra,* with reference to performance bonds required to be furnished by contractors. Indeed the sections of both the House and Senate Reports where the commentary cited by the Third Circuit appeals would support such a view. (Pet. App. 18a-19a). In such situations, it is obvious that when a surety provides a performance bond which includes a guarantee of payment of payroll taxes, or alternately, when a lender provides a performance bond by guaranteeing payment of payroll taxes under 40 U.S.C. § 270a(d), that both the surety and the lender are acting as guarantors of the taxes, thereby subjecting themselves to an absolute liability in the event that such taxes are not paid by the contractor. In this context, the surety can provide

protection by increasing the premiums on the performance bond, and the lender can likewise provide protection by increasing its loan fees and taking additional security to cover such potential loss.

Such absolute liability is not the case, however, under Section 3505. It is submitted therefore that the legislative history cited by the Third Circuit in the instant case does not support its interpretation of Section 3505 of the Code.

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CONCLUSION

For the foregoing reasons, the petitioner, Jersey Shore State Bank, respectfully prays that this Court reverse the judgment of the court of appeals and order reinstatement of the judgment of the district court.

Respectfully submitted,

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July 29, 1986